(3)

No. 84-165

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

W. GEORGE GOULD,

Petitioner,

v.

MAX A. RUEFENACHT,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF FOR PETITIONER

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QUESTION PRESENTED

Is the purchaser of half of a business, who obtains absolute veto power over all major business decisions, intends to share all top level decisions of the firm, and actively participates in the company's affairs, entitled to federal securities law protection simply because the transaction was structured as a stock purchase?

LIST OF PARTIES TO THE PROCEEDINGS IN THE COURT OF APPEALS

Appellant

MAX A. RUEFENACHT

Appellees

W. GEORGE GOULD
CHRISTOPHER J. O'HALLORAN
DAVID BERNSTEIN

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BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the District Court for the District of New Jersey, dated April 21, 1982, (J.A. 45a-50a), denying defendants' motion for summary judgment without prejudice and referring the matter to the Magistrate for a hearing, is not reported. The report and recommendation of the Magistrate, dated January 31, 1983, is reproduced at J.A. 51a-56a. The opinion of the District Court for the District of New Jersey, dated April 15, 1983 (J.A. 57a-62a), dismissing the complaint, is not reported. The opinion of the Court of Appeals, entered

June 11, 1983 (Pet. App. A, 2a-43a), reversing the judgment of dismissal is reported at 737 F.2d 320 (3rd Cir. 1984).

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals was entered on June 11, 1984 (Pet. App. A, 2a-43a). A petition for a writ of certiorari was timely filed on July 27, 1984 and was granted on November 13, 1984.

STATUTORY PROVISIONS INVOLVED

The statutory provisions involved are those sections of the Securities Act of 1933 and the Securities Exchange Act of 1934 that define the term "security." The definition contained in the Securities Act of 1933 is as follows:

> When used in this subchapter, *unless the context otherwise requires—*
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contact, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including an interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1)(1982) (emphasis added).

The definition of "security" contained in the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10) (1982), is, for present purposes, essentially identical. In each instance, the definition is preceded by the phrase "unless the context otherwise requires." The Securities Act of 1933 and the Securities Exchange Act of 1934 will hereafter be referred to collectively as the "securities laws."

Other statutory provisions involved herein are sections 12 and 17 of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934, including Securities and Exchange Commission Rule 10b-5 promulgated thereunder. These provisions are reproduced at Pet. Apps. C through E.

STATEMENT OF THE CASE

A. Circumstances of the Transaction

In June, 1980 plaintiff-respondent Max A. Ruefenacht ("Ruefenacht") purchased 2500 newly-issued shares of the common stock of Continental Import and Export, Inc. ("Continental"), an importer and distributer of wines and spirits. As a result of the purchase, Ruefenacht owned 50% of the company's outstanding shares (J.A. 52a).

The agreed-upon purchase price was $250,000, a sum which reflected a "discount" to Ruefenacht in return for his agreement to actively participate in Continental's business (J.A. 46a). In addition, in connection with the stock purchase Ruefenacht acquired multifaceted control over the company's affairs, and in fact actively participated therein, to wit: (1) he acquired the right to veto all major company decisions, both structural and operational, including stock issuance, liquidation, obtaining new product lines and borrowing funds (J.A. 53a, 56a); (2) he was to become chairman of the board of directors and receive a salary of $24,000 annually (J.A. 53a); (3) he was extensively involved in numerous regular meetings with suppliers, and solicited contracts to import beverages on behalf of the firm (J.A. 54a-55a); (4) he actively participated in the company's sales and marketing efforts, in connection with

which he applied for and received a state liquor license (or solicitor's permit), representing therein that he would sell alcoholic beverages to wholesalers and receive in return a salary and compensation for expenses (J.A. 47a); (5) he became a signatory for Continental's checks, and to do so denominated himself as the company's vice-president and treasurer (J.A. 46a-47a,53a); (6) he substantially influenced or directed the hiring of key personnel (J.A. 53a-54a); and (7) he issued directions to Continental's counsel regarding securing wine label approvals (J.A. 55a). Ruefenacht paid $120,000 of the total $250,000 purchase price for Continental's stock, and shortly thereafter abruptly withdrew from the company (J.A. 47a).

B. The Proceedings Below

Ruefenacht then commenced this action, alleging that his purchase of Continental stock was induced by fraudulent and negligent misrepresentations contained in certain financial documents prepared by Christopher O'Halloran (the company's accountant), and made orally by defendants Joachim Birkle (Continental's president, who owned or controlled the remaining 50% of Continental's stock), and petitioner W. George Gould (Continental's corporate counsel). Violations are alleged of sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. 771(2), 77q(a) (1982); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b) (1982); and Rule 10b-5, 17 C.F.R. 240.10b-5 (1984).[1] Also alleged are pendent state claims for fraud and breach of fiduciary duties. The complaint seeks rescission and restitution of the amount paid (J.A. 23a-44a).

Defendant-petitioner Gould moved for summary judgment dismissing the complaint on the ground that limited discovery showed Ruefenacht to have acquired such significant control over Continental's business, and to have participated in the

[1]Hereinafter the Securities Act of 1933, as amended, 15 U.S.C. §§ 77a-77bbbb (1982), will be referred to as the "Securities Act"; and the Securities Exchange Act of 1934, as amended, 15 U.S.C.§§ 78a-78kk (1982), will be referred to as the "Securities Exchange Act."

company's affairs to such a degree, that his stock purchase was not an idle investment with profits to come solely or primarily from the efforts of others. Therefore, Ruefenacht could not claim protection under the federal securities laws, pursuant to the authority of *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, *reh. denied*, 329 U.S. 81 (1946); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); and *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

The trial court held an evidentiary hearing[2] on the issue of the extent of control over Continental acquired by Ruefenacht in connection with the stock purchase. A number of specific factual findings (summarized under section A above) were made (J.A. 51a-56a), providing the basis for the ultimate factual conclusions that Ruefenacht *was* "an active investor who intended to participate significantly in the management of the business," and *not* "a passive investor who relied on others to manage the business" (J.A. 61a). As a result of Ruefenacht's control over and participation in Continental's affairs, the trial court held that "the profits of the enterprise would not be derived 'solely' or substantially from the efforts of others," and, therefore, under the authority of *Howey*, *Forman* and *Weaver*, dismissed all federal securities law claims. Additionally, the court in its discretion dismissed all pendent state law causes of action (J.A. 61a-62a).

On Ruefenacht's appeal, the Third Circuit held that no economic analysis of the transaction should have been made, and that the securities laws apply to the transaction *a fortiori* because stock with "traditional" attributes was involved. Accordingly, the judgment dismissing Ruefenacht's complaint was reversed and the matter remanded. *Ruefenacht v. O'Halloran*, 737 F.2d 320 (3d Cir. 1984).

[2]The matter was referred to the Magistrate who, after receiving testimonial and documentary evidence, rendered a report and recommendations (J.A. 51a).

SUMMARY OF ARGUMENT

I

The federal securities laws protect passive investments in financial instruments that usually are publicly marketable, and not purchases of assets (such as a business or its property) which may be accomplished by a transfer of stock.

The dominant purposes of the securities laws are to regulate the organized capital markets and to protect "investors." An "investor" in stock in a securities law sense is characterized by an intent to purchase the instrument as an end in itself, and not as a means of acquiring ownership or control over the underlying business or its property. An investor also is characterized by a dependence upon others for information relevant to his purchase, and for a return (or profit) on the capital provided for others' use. In contrast, a non-investor fundamentally seeks to utilize stock as a means to acquire ownership or use of a business or its property. Such a person is in a position to protect himself at various stages of the transaction by obtaining firsthand information, and by influencing corporate profitability.

Securities law protection in particular cases is properly determined, in the light of these dominating statutory purposes, by reference to the economic substance of the transaction. The decision in *Howey* sets forth the key economic determinants of securities law coverage, which are reflective of the statutory goals. Application of the *Howey* criteria to a transaction in stock is entirely consistent with decisional precedent in this Court and with the statutory design.

II

The present transaction fails to qualify for securities law protection under this analysis, because it implicates no federal securities laws concerns.

The transaction fails to satisfy the *Howey* criteria initially because it was entirely private and unique in character, and not

public in any sense. Moreover, because of Ruefenacht's extensive veto rights over fundamental corporate decisions, and his ability to influence the firm's profitability through active participation in its affairs, the transaction does not satisfy the *Howey* requirement that an investment in a "security" be characterized by an expectation of profits to be obtained from the efforts of others. These circumstances require that the federal securities law claims be dismissed, and that the contrary decision and judgment of the Third Circuit Court of Appeals be reversed.

POINT I

THE SECURITIES LAWS PROTECT PASSIVE INVESTMENTS IN FINANCIAL INSTRUMENTS WHICH ARE USUALLY PUBLICLY MARKETABLE, AND NOT PURCHASES OF ASSETS BY MEANS OF A STOCK TRANSFER

This petition seeks to have the Court continue an approach to the determination of federal securities law coverage which it has faithfully followed over the decades. Beginning with *Howey*, the Court *always* has looked to the economic substance of the transactions before it, in the light of the protective purposes of the securities laws, to evaluate whether those purposes will be advanced by according coverage. In the early decades after passage of the securities laws, the Court construed the enactments flexibly to afford coverage to persons and transactions within the spirit but not within the letter of the statutes. But it does not follow from this early history that securities law coverage should now be extended to transactions within the statutes' letter but not their spirit.

The cases show that the paradigm of a "security"[3] in the federal law sense is a passive investment in a financial instrument which is usually publicly marketable. In contrast, this

[3]The definition of "security" under the Securities Act is found at 15 U.S.C. 77b(1) (1982); in the Securities Exchange Act the definition is found at 15 U.S.C. 78c(a)(10) (1982).

Court has never held the securities laws to apply to the purchase or sale of assets to be used or consumed by the purchaser. One form of such an asset purchase is the sale of a business, in whole or in part, which on occasion may be accomplished by means of a transfer of stock.

The present case, in economic substance, involves the purchase of a business, and not an idle investment in a financial instrument. It is, as a result, not within the spirit or intendment of the securities laws, and hence is disqualified from coverage thereunder.

A. The Dominant Purposes Of The Securities Laws Are To Protect Investors Dealing In Public Markets, Not Non-Investors Who Use or Consume The Item Purchased

The dominant purposes of the securities laws are to regulate the capital markets and to protect "investors" through compelled disclosures. As stated in *Forman*, 421 U.S. at 849:

> The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors.

Accord Weaver, 455 U.S. at 555 ("The Act was adopted to restore investors' confidence in the financial markets . . ."); and *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) ("One of its [the Security Exchange Act's] central purposes is to protect investors through the requirement of full disclosure by issuers of securities, and the definition of security in § 3(a)(10) necessarily determines the classes of investments and investors which will receive the Act's protections.").

Both factions in the current judicial debate as to when stock is a "security" agree that these were Congress' fundamental aims. *Ruefenacht v. O'Halloran*, 737 F.2d at 334 ("Congress unquestionably intended that the Act protect 'investors' in the national securities markets."); *Daily v. Morgan*, 701 F.2d 496, 500 (5th Cir. 1983) ("There is no doubt that Congress was primarily concerned with abuses occurring in the financial markets—the national exhanges and over-the-counter markets—through the sales of widely-held securities of large corporations. The legislative history is abundantly clear on this point . . . ."); *Golden v. Garafolo*, 678 F.2d 1139, 1146 (2d Cir. 1982) ("The overbreadth is the consequence of the fact that Congress' core concern was protection of the individual investor trading in public markets for shares of firms about which information is available only through intermediaries."). *Accord Sutter v. Groen*, 687 F.2d 197, 201 (7th Cir. 1982) ("We must ask in other words what class of people Congress wanted to protect by enacting the Securities Exchange Act, and in particular section 10(b). The answer is not in doubt: investors.").

These purposes recently were confirmed by Congress itself in enacting amendments to the definitions of "security" in the Securities Act and Securities Exchange Act. *See* Act of October 13, 1982, Pub. L.97-303, § 1, 96 Stat. 1409. The purpose of the amendments was to resolve a jurisdictional conflict between the Securities and Exchange Commission and other agencies regarding the regulation of various securities options by specifically adding certain types of options to the definitions of a security. *See* 1982 U.S. Code Cong. & Ad. News 2780. The legislative history of the amendments provides in pertinent part that:

> These laws were aimed at *protecting public investors*, assuring market integrity and, most important, restoring investor confidence in order to attract needed funds back into the U.S. capital markets. These goals were, and remain, of paramount concern to Congress.

1982 U.S. Code Cong. & Ad. News at 2781 (emphasis added).This statement reaffirms the primacy, in the securities laws, of the protection of "investors" dealing in "public" markets.

Inherent in this statutory design is a fundamental distinction, at the bottom of the securities laws, between investors and non-investors (or between investments and non-investments). A basic premise of petitioner's position is that Congress intended to draw this distinction, with the result that non-investors are not entitled to federal securities law protection, even though they choose to transact in stock facially meeting the statutory definition of a security. This distinction also is the foundation for the "sale of business doctrine."[4] *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1352 (9th Cir. 1984); *Sutter v. Groen*, 687 F.2d at 201; *Golden v. Garafolo*, 678 F.2d at 1146.

In the broadest generic sense, almost any purchase, at least in part, can be considered an "investment," and hence any purchaser an "investor." Thus, for example, although the purchase of a house or other necessaries are primarily for use or consumption, to the extent a purchaser expects these assets to appreciate in value they can be considered investments as well. It is self-evident, though, that this general sense of the term is not intended to be the basis for securities law coverage.

The fundamental distinction between an investor and a non-investor in a securities context has been described in various ways. *Forman*, citing *Howey*, described an investor as someone "'attracted solely by the prospects of a return' on his investment." *Forman*, 421 U.S. at 852 (citing *Howey*, 328 U.S. at 300). *Forman* contrasted such a person with someone "motivated by a desire to use or consume the item purchased . . . ," 421 U.S. 852-53, to whom the securities laws do not apply. *S.E.C. v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), stated that where an asset becomes the subject of "speculation," it becomes more akin to an investment. *Id.* at 352 n.10. The Seventh Circuit described the distinction as

[4]The sale of business doctrine is merely a shorthand expression for the principle that where the economic essence of a stock transfer is the sale of an asset (*i.e.*, a business), the securities laws do not apply. *See e.g.*, *Golden v. Garafolo*, 678 F.2d at 1140-42.

being between an investor and an entrepreneur, and defined the "entrepreneurial intention" as one "to buy assets to manage, rather than to rent capital to those who want to manage . . ." *Sutter v. Groen*, 687 F.2d at 202.

Emerging from these descriptions is a portrait of an investor as someone who acquires stock in a business as an end in itself; the investment is fundamentally in the financial instrument and not in assets. Stated differently, the stock investor in a securities law sense seeks gain from the fact of ownership of the instrument, and not from his own control or use of the business or its assets. In contrast, a dominant purpose of a non-investor is to acquire ownership or use of assets (*i.e.*, a business or its property), although it may occur that a transfer of stock is utilized as a means to that end. But it is the underlying business entity, and not the instrument, which is the focus of the non-investor's purchase.

An investor is also characterized by a dependence upon others for information relevant to his purchase, and for a return on his investment thereafter. *See Golden v. Garafolo*, 678 F.2d at 1146 (" . . . Congress' core concern was protection of the individual investor trading in public markets for shares of firms about which information is available only through intermediaries.").

It is this element of dependence by investors upon others that renders the latter fiduciaries, owing to investors high duties of trust. The legislative history is clear on this point. As stated by President Franklin D. Roosevelt in his message to the United States Senate:

> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
>
> * * *
>
> What we seek is a return to a clearer understanding of the

ancient truth that *those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others.*

77 Cong. Rec. 937 (1933) (emphasis added).

A similar perspective was presented by Congressman Sam Rayburn, a sponsor of the Securities Act, who during his remarks on the floor of the House of Representatives stated:

> [T]he development of this country impresses one that the size of our industrial unit is increasing, and with its growth there has come a dispersion in the ownership of the unit. Today an important part of the wealth of individual citizens consists of interest in great enterprises of which no single person owns a major portion. *Today the owner does not possess actual physical properties but he holds a piece of paper which represents certain rights and expectations. But the owners of these pieces of paper have little control over the physical property; the owners of these pieces of paper carry no actual responsibility with respect to the enterprise or its physical property.*
>
> * * *
>
> We have, on the one hand, 18,000,000 passive citizens having no actual contact with their companies; on the other hand, a few hundred powerful managers directing and controlling the destinies of the companies and the physical properties which they own. The owners of these symbols are entitled to know what the symbols represent. Those who are interested in purchasing these pieces of paper have the right to demand information as to the actual condition of the issuing company. Up to this time such information has depended on the grace of an intrenched management. *These managers are truly trustees. One of their duties as trustees is to furnish security owners, in being and in prospect, with reliable information. This bill has been drawn to enforce that responsibility.*

77 Cong. Rec. 2910, 2917-18 (1933) (emphasis added). The House Committee Report on the Securities Exchange Act is to the same effect:

> As a complex society so diffuses and differentiates the financial interests of the *ordinary citizen that he has to trust others* and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's *dependent position.*

H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5, 78 Cong. Rec. 7703 (1934) (emphasis added).

Thus, a purchaser of stock who is not in a position to obtain or confirm relevant firsthand information regarding a business prior to engaging in a transaction, and who must rely virtually entirely upon others for management of the enterprise, because of his vulnerable position presents a model for coverage under the federal securities laws. Where, in contrast, the purchaser is in a position to protect himself before the transaction by obtaining firsthand information (perhaps by the exercise of an element of negotiating power), and, in addition, after the purchase possesses such control or influence over the enterprise that he is in a position to further protect himself (perhaps by mitigating the effects of fraud or inhibiting further abuses), the protective policies of the securities laws are not implicated. Such a person, able to protect himself at various stages of the transaction, is not an "investor" under the conceptions cited above.

The fact that the dominant purposes of the securities laws are protection of investors and regulation of public markets does not necessarily exclude non-investors who transact privately from coverage by those laws. *United States v. Naftalin*, 441 U.S. 768, 775 (1979) ("But neither this Court nor Congress has ever suggested that investor protection was the sole purpose of the Securities Act."); *Daily v. Morgan*, 701 F.2d at 502 ("However, the fact that Congress was concerned primarily

with large-scale fraud in the capital markets does not mean that it would disapprove of statutory protection against small-scale fraud as well."). But if coverage is to be extended to non-investors, there should be sufficient, even compelling reasons, related to securities regulation, to do so. Certainly, coverage will not be accorded simply because fraud is alleged in connection with a transaction where stock is transferred. The securities laws do not "provide a broad federal remedy for all fraud." *Weaver*, 455 U.S. at 556. Nor, we submit, do the securities laws provide a federal remedy for all fraud where stock is somehow involved in the transaction.

There are no compelling reasons to extend securities law coverage to non-investors, and in fact good reasons not to do so.[5] Such an extension of coverage obliterates the fundamental distinction between investor and non-investor. It also accords coverage to infinitely broad classes of persons and transactions, in effect making the securities laws a "broad federal remedy for all fraud," *Weaver*, 455 U.S. at 556, where stock in any way is involved in the transaction. Such an approach extends securities law coverage to classes of persons and legions of transactions which Congress gave absolutely no indication that it sought to protect. *See Sutter v. Groen*, 687 F.2d at 201 ("No other protected class [besides investors] is mentioned [in the legislative history]; entrepreneurs are not mentioned.") To paraphrase the Court below, if Congress intended the securities laws to cover non-investors, "they certainly made no mention of it." *Ruefenacht v. O'Halloran*, 737 F.2d at 330.

[5]It should be pointed out that the private right of action under section 10b and Rule 10b-5 is not one of express legislative enactment, but has been implied by the courts. As such, the parameters of its application are a matter of judicial determination based on the judicial perception of the classes of persons intended to be protected by the statute's underlying purposes. The same is true as to any private right of action that may exist under Section 17 of the Securities Act. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, *reh. denied*, 423 U.S. 884 (1975). To a lesser extent, such discretion may even by exercised by the courts with respect to Section 12 of the Securities Act where Congressionally created rights are involved.

B. Whether The Purposes Of The Securities Laws Will Be Advanced By According Coverage Is Determined By Reference To The Economic Substance Of The Transaction

Decisional precedent in this Court, and statutory authority, fully support an evaluation of the economic substance of a transaction, in the light of the statutes' dominating purposes, to determine securities law coverage.

1) Supreme Court Precedent.

Authority for such an approach is found initially in the axiom of statutory construction that, in determining coverage, every enactment should be read as a whole and in light of its dominant purposes. As stated in *Kokoszka v. Belford*, 417 U.S. 642, *reh. denied*, 419 U.S. 886 (1974):

> When "interpreting a statute, the court will not look merely to a particular clause in which general words may be used, but will take in connection with it the whole statute (or statutes on the same subject) and the objects and policy of the law, as indicated by its various provisions, and give to it such a construction as will carry into execution the will of the Legislature . . ." *Brown v. Duchesne*, 19 How. 183, 194 (1857).

417 U.S. at 650. *See also FAA Administrator v. Robertson*, 422 U.S. 255, 261 (1975).

In *Joiner*, this principle was applied to find oil leases, sold as part of an exploration enterprise, to be securities under federal law. The Court rejected application of a specific rule of statutory construction (*expressio unius est exclusio alterius*) where such application would have led to a result at odds with the enactment's objects and policy, to wit:

> However well these rules [of statutory construction] may serve at times to aid in deciphering legislative intent, they long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of

> context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy.

Joiner, 320 U.S. at 350-51 (footnote omitted).

The Court in *Forman* similarly emphasized the importance of this approach in carving the scope of the meaning of "security" under federal law. The Court stated that "construing these Acts against the background of their purpose," 421 U.S. at 849, may require excluding from statutory coverage even transactions that fall within the letter of the enactments, citing *Holy Trinity v. United States*, 143 U.S. 457, 459 (1892), for the oft-repeated proposition that:

> [A] thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers.

One obvious purpose of construing a statute in the "context" of its dominant purposes is to avoid sweeping within the law transactions and classes of persons which literally may seem to be covered, but which are in fact not within the legislation's "spirit, nor within the intention of its makers." *Id. Cf. Nat. Soc. of Professional Engineers v. U.S.*, 435 U.S. 679, 687 (1978) (stating that Section 1 of the Sherman Act, 15 U.S.C. § 1, "cannot mean what it says."). Put another way, application of this principle guards against unnecessarily extending statutory coverage to matters where to do so would neither advance nor implicate the protective purposes of the law.

Adhering consistently to these principles, for decades this Court has held that coverage of the securities laws is evaluated in light of the economic realities of a transaction and not woodenly applied based upon a literal application of the statutes. *Howey*, 328 U.S. at 299 (the definition of security "embodies a flexible rather than a static principle . . ."); *Forman*, 421 U.S. at 850 (observing that *Joiner* "was not establishing an inflexible rule barring inquiry into the economic realities underlying a transaction."). This approach has led, in cases in this Court

where securities law protection was sought, to an evaluation of the economic substance of the transaction. Where, after such an analysis, the Court has concluded that the statutory purposes will be advanced, securities law coverage has been accorded. *See, e.g., Tcherepnin*, (withdrawable capital shares in a savings and loan association held to be securities); *Howey*, (interests in orange groves as part of an arrangement for cultivating, marketing and remitting the net proceeds to the investor were securities); and *Joiner*, (oil leases sold as part of an exploration enterprise were securities). Where the statutory purposes have not been implicated, coverage has been denied. *See, e.g., Weaver*, (certificates of deposit, and a private contract to share profits where the plaintiff had use of assets in the business, held not to be securities); *Teamsters v. Daniel*, 439 U.S. 551 (1979) (interest in pension plan not a security); and *Forman*, (stock in non-profit housing cooperative not a security). Although the economic analysis in some cases (*i.e., Tcherepnin, Howey* and *Joiner*) resulted in an extension of securities law protection to transactions which facially did not meet the statutory definition, the Court never stated that such an analysis was only a one-way street, to be utilized solely where the result would be to expand securities law coverage. No case mentions such a restriction, which would be fundamentally at odds with the principle that every enactment should be construed in light of its purposes. Fidelity to this principle requires that no transaction be immunized from substantive evaluation. The result is neither to expand nor contract the enactments' scope, but rather to *conform* the same to the statutory goals.

The opportunity for courts to evaluate the economic substance of transactions where federal securities law protection is sought was made explicit in *Forman*. The Court there rejected a "literal" approach to application of the securities laws in no uncertain terms:

> We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply

because the statutory definition of a security includes the words "any . . . stock." Rather we adhere to the basic principle that has guided all of the Court's decisions in this area:

> "[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality."

Forman, 421 U.S. at 848 (quoting *Tcherepnin*, 389 U.S. at 332).

The necessity for courts to be able to examine the economic realities underlying a transaction is a product of the fact that the definitions of "security" in the securities acts consist simply of a listing of some of the many and variable instruments and business arrangements identified by Congress as potential securities. As the *Forman* Court stated:

> In providing this definition Congress did not attempt to articulate the relevant *economic criteria* for distinguishing "securities" from "non-securities." Rather, it sought to define "the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."

421 U.S. at 847-48 (citing H.R. Rep. No. 85. 73d Cong., lst Sess. 11 (1933)) (emphasis added).

The *Forman* Court also observed:

> Because securities transactions are economic in character Congress intended the application of these statutes to turn on the *economic realities underlying a transaction*, and not on the name appended thereto.

421 U.S. at 849 (emphasis added).

Use of an economic analysis to determine securities law coverage was confirmed in *Weaver*, where the Court stated, in unmistakable terms, that in determining federal securities law coverage:

> *Each transaction* must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

455 U.S. at 560 n.11 (emphasis added).

Forman does not forbid an evaluation of the economic substance of "traditional" instruments. *See Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983); *Golden v. Garofalo*, 678 F.2d 1139 (2d Cir. 1982); *Coffin v. Polishing Machines, Inc.*, 596 F.2d 1202 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). The source of this erroneous interpretation is *Forman*'s reference to the "traditional" characteristics of stock. In the course of rejecting the literalist view that the name given an instrument is controlling of securities law coverage, the Court stated:

> In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

421 U.S. at 850-51. *Forman*'s reference to "traditional" securities or their characteristics was in the context of discussing a situation where a purchaser reasonably assumes the securities laws to apply (*i.e.*, where a purchaser is "misled," 421 U.S. at 851, into such a belief). By the above quote and following discussion, *Forman* simply stated that such a claim is strengthened where "traditional" securities are involved, because it is more likely that such an expectation would be created in that circumstance.[6]

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[6]As we show *infra* under Point IC1, the presence of a "traditional" label, such as stock, and attendant "traditional" characteristics, plays a role in determining securities law coverage. Such instruments are presumptively covered by the statutes, subject to rebuttal where the economic realities of the transaction so require.

2) The Context Clauses

The phrase "unless the context otherwise requires," preceding the definitions of the term "security" in both the Securities Act and Securities Exchange Act[7], provides express statutory authority for an evaluation of the economic substance of transactions where securities law protection is sought. *Weaver* makes this clear: "[T]he terms mentioned [in the statutory definition of the term 'security'] are not to be considered securities if 'the context otherwise requires . . . .'" 455 U.S. at 556.

The analysis by the Court below of the origins of the context clauses does not affect this conclusion. *Ruefenacht v. O'Halloran*, 737 F.2d at 330-32. The absence of discussion in the legislative history of the securities laws reconciling the two versions of the prefatory clause proves no more than that Congress never specifically considered whether the sale of a business by means of a transfer of stock is covered by the securities laws. *Daily v. Morgan*, 701 F.2d at 502 ("As far as we can tell from the legislative history, Congress never pondered the sale of business question, being concerned with the grander problems of the day.") In short, no historical analysis or legislative history precludes an analysis of whether, in economic substance, a sale of all or part of a business by the transfer of stock is a transaction in securities under federal law.

Even if, as the Third Circuit suggests, the relevant context is the text of the statute, rather than the economic and factual setting, *see Ruefenacht v. O'Halloran*, 737 F.2d at 330, statutory provisions involved in this case are set in a linguistic context suggesting a need to determine securities law coverage by reference to the statutory purposes. For example, section 10b of the Securities Act, 15 U.S.C.§ 78j, provides:

> § 78j. Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate

[7]*See supra* note 3.

> commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate *in the public interest* or for the *protection of investors*.

15 U.S.C. § 78j (1982) (emphasis added). The statutory context in which the term "security" is used in section 10b is one where emphasis is placed on the "protection of investors" and the "public interest." Thus, from a textual point of view the meaning of these qualifying terms becomes important in determining the nature of "security" transactions intended to be covered by this section. As shown *supra* under Point IA, basic to this context is a distinction in the law between an "investor" and a "non-investor," and a design to extend securities law coverage only to the former.[8]

Even the Court below, and other Courts of Appeals which reject an economic analysis of transactions involving tradi-

[8]A further statutory "context" of section 10b is that it is immediately preceded by the section that proscribes market manipulation (15 U.S.C. § 78i) and immediately followed by the section that regulates trading by exchange members, brokers and dealers (15 U.S.C. § 78k). Each of these sections deals with prohibited activities on public exchanges, confirming that Congress' dominant (although not exclusive) focus was on regulating the organized capital markets whose operations affect large numbers of persons. As discussed *infra* under Point IC, this focus, while not necessarily excluding private transactions from securities law coverage, makes clear that the protective purposes of those laws are implicated most strongly where a transaction in stock is public, or widespread, in nature; and that those statutes are concerned only minimally with transactions that are entirely private or unique.

tional stock,[9] have applied the context clauses to justify an economic analysis of transactions in *notes*, and to support conclusions that some note transactions are not covered by the securities laws, even though the instruments are facially "traditional." *Exchange National Bank of Chicago v. Touche Ross Co.*, 544 F.2d 1126, 1131-32 (2d Cir. 1976); *Ruefenacht v. O'Halloran*, 737 F.2d at 323-24. *See also Hunssinger v. Rockford Business Credits, Inc.*, 745 F.2d 484 (7th Cir. 1984); *Landreth Timber Co. v. Landreth*, 731 F.2d 1348 (9th Cir. 1984).

According to the Court below, in the note area there is "some necessity" for such "fine-tuning" of the definition of security, *Ruefenacht v. O'Halloran*, 737 F.2d at 325, in order to avoid sweeping within the securities laws transactions clearly not intended to be covered, which advance no statutory purpose, but which would be covered under a literal approach. Different tests have evolved to distinguish covered from non-covered notes — a "risk capital" test, an "investment" test, and the *Howey* approach, *see* 737 F.2d at 323-24 — and the debate persists as to the merits of each. *Id.* The Third Circuit, in seeking to distinguish between covered and non-covered note transactions has ". . . examined the *entire context* of the note transaction, declining at that time to expound a 'test' . . . that would aid in determining whether there has been a purchase or sale of securities when a personal promissory note is involved." *Ruefenacht v. O'Halloran*, 737 F.2d at 323, citing *Lino v. City Investing Co.*, 487 F.2d 689, 696 n.15 (3d Cir. 1973) (emphasis added). In short, even those courts which reject an economic analysis of transactions in a stock setting, embrace such an approach to evaluate note transactions (albeit using somewhat different tests), to prevent extending securities law coverage where not warranted or necessary.

There is no principled way to reconcile the conclusions that transactions involving notes, which are traditional instruments, may be subject to substantive economic evaluation to determine securities law coverage, but the same is not true for traditional stock. *See Landreth Timber Co. v. Landreth*, 731 F.2d at 1353. Nor is it sufficient to say that, unlike in the note setting, there is "no . . . necessity in the stock area" for such an approach. *Ruefenacht v. O'Halloran*, 737 F.2d at 325. The very same compelling rationale applies to both instruments, namely, the need to avoid sweeping within the statute legions of transactions not intended to be covered and where extending securities law protection would advance no statutory purpose.

[9]*Ruefenacht v. O'Halloran*, 737 F.2d 320 (3d Cir. 1984). *See also Daily v. Morgan*, 701 F.2d 496 (5th Cir. 1983); *Golden v. Garafolo*, 678 F.2d 1139 (2d Cir. 1982).

C. The Economic Factors Cited In *Howey* Permit Extension Of Securities Law Coverage To A Passive Investment In A Financial Instrument, And Denial Of Coverage To The Purchase Of A Business by Means Of A Stock Transfer

The guiding principles set forth in *Howey* are the starting point in the analysis of the economic substance of a transaction where federal securities law protection is sought. *Howey* concluded that an "investment contract" is characterized by "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." *Forman*, 421 U.S. at 852. As stated in *Forman*, these factors are the "touchstone[s]" of the meaning of "security" in federal law, and embody "the essential attributes that run through all of the Court's decisions defining a security." *Forman*, 421 U.S. at 852.

These factors stitch a common thread through the definition of security because they reflect, "in shorthand form," *Forman*, 421 U.S. at 852, an economic substance common to *all* instruments enumerated within the statutory definition. This point is missed by those courts which argue that application of the *Howey* factors to stock distorts the statutory definition by "circumscrib[ing] the scope of the standard terms—'stock', 'note', 'debenture'—to that of the more generous phrases [*e.g.*, investment contract]." *Ruefenacht v. O'Halloran*, 737 F.2d at 329. *See also Golden v. Garafolo*, 678 F.2d at 1144. Whether the "investment" in a security is in stock or in an investment

contract, the transaction must possess these essential attributes to be considered a transaction in a "security" in the federal law sense.

1) Common Venture

The *Howey* requirement of an investment in a "common venture" puts in focus the extent to which a transaction in securities is widespread or "public" in nature. Decisions by this Court consistently have recognized, explicitly or implicitly, the importance of this factor. Thus, in *Joiner*, the campaign to sell assignments of oil leases "was by mail addressed to upwards of 1000 prospects in widely scattered parts of the country and actual purchasers, about fifty in number, were located in at least eighteen states and the District of Columbia." *Joiner*, 320 U.S. at 346. In *Howey*, the units of citrus grove development and related service contracts were offered "to the public," 328 U.S. at 295, many of whom lived in "distant localities," *id.* at 299, and in a limited period 42 persons made purchases. *Id.* at 295. In *Tcherepnin*, the withdrawable capital shares were offered widely to the public, in part through printed solicitations sent through the mails. 389 U.S. at 333. As summarized in *Weaver*: "The unusual instruments found to constitute securities in prior cases involved offers to a number of potential investors, not a private transaction as in this case." 455 U.S. at 559.[10]

The principle emerging from these cases is that the more widespread is an offering of stock, the more the protective purposes of the securities laws are implicated. As an offering becomes increasingly widespread, it progressively involves the "public investor," *supra* at p.9, about whom Congress in enacting the securities laws was most concerned. Conversely, to the extent that a transaction in stock is singular or entirely private in character, the protective purposes of the securities laws are implicated to a lesser degree. Thus, in *Weaver*, an important

[10] *See also Great W. Bank Trust v. Kotz*, 532 F.2d 1252, 1258 (9th Cir. 1976); *Lino v. City Investing Co.*, 487 F.2d 689, 694-95 (3d Cir. 1973); *Robbins v. First Am. Bank*, 514 F. Supp. 1183, 1188 (N.D. Ill. 1981).

factor in rejecting securities law coverage of a private contract was that the agreement was "unique," was "negotiated one-on-one by the parties," was not distributed to other potential investors, and was "not designed to be traded publicly." 455 U.S. at 560. Such a private transaction bespeaks elements of negotiation between the parties, and an ability to obtain first-hand information, which places a potential plaintiff in a position to protect himself in the transaction through negotiated disclosures, warranties or other contractual protections. Such a person has little need or cause to claim securities laws protection.

This is not to say that private or face-to-face transactions are *necessarily* excluded from securities law coverage. It is established that the securities laws may apply "to face-to-face sales of stock as well as to transactons in the recognized markets." *Ruefenacht v. O'Halloran*, 737 F.2d at 328; *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6,10 (1971). But on the spectrum from, on one hand, a totally unique transaction between two private contracting parties of equivalent bargaining power who choose to deal in stock, to, on the other, a widespread standardized offering to thousands of distant potential purchasers, it is clear that as the transaction approaches the latter model the protective purposes of the securities laws are increasingly implicated, and hence coverage under those laws becomes progressively certain.[11]

2) Expectation of Profits to be Derived From the Efforts of Others

The requirement that the economic inducement for an "investment" subject to the securities laws be a promise or

[11] There is nothing to the contrary in *United States v. Naftalin*, 441 U.S. 768 (1979), where the Court upheld the criminal conviction of a customer for defrauding his stockbroker in short sale transactions. The Court emphasized that the statutory purpose advanced by according securities law coverage was "to achieve a high standard of business ethics . . . *in every facet of the securities industry.*" *Id.* at 775 (quoting *S.E.C. v. Capital Gains Bureau, Inc.*, 375 U.S. 180, 186–87 (1963)). As shown earlier (*supra* at p. 8-10), regulation of activities in the securities industry (*i.e.*, on the organized exchanges) was clearly one of the primary purposes of the securities laws.

expectation of profits was made clear in *Forman*, where a prime reason for rejecting coverage was the fundamental nonprofit nature of the transaction. *Forman*, 421 U.S. at 853-58. *Accord Daniel*, 439 U.S. at 561-62.

The concept that profits must be "derived from the entrepreneurial or managerial efforts of others," *Forman*, 421 U.S. at 852, encompasses factors relating both to the amount of control possessed by a potential plaintiff and the extent of his activity in the business whose stock is transferred. *Landreth Timber Co. v. Landreth*, 731 F.2d at 1352; *Sutter v. Groen*, 687 F.2d at 202; *Golden v. Garafolo*, 678 F.2d at 1141-42; *King v. Winkler* 673 F.2d 342, 344-45 (11th Cir. 1982). To the extent that a purchaser of stock obtains significant control[12] over fundamental corporate decisions, he is in a position to affect decisions bearing on profitability, and hence is not in the totally dependent position of the paradigmatic "investor" the securities laws seek to protect. The determination in *Weaver* that a "measure of control," 455 U.S. at 560, over the business there militated against securities law coverage supports this conclusion. *See also Landreth Timber Co. v. Landreth*, 731 F.2d at 1352 (" . . . when a person purchases control of a business, he does not make an investment from which he expects profits solely from the efforts of others."). Similarly, where a purchaser of stock actively participates in the enterprise, he may be in a position by his efforts to affect corporate profitability, with the result that he again is not totally dependent upon others for a return of profit. *Golden v. Garafolo*, 678 F.2d at 1149 (Lumbard J., dissenting).

These determinations turn not upon any *per se* "test" (such as the percentage of stock acquired), but must be viewed

[12]Corporate control in a securities law context means the ability to influence corporate direction or policy. *See* 17 C.F.R. § § 230.405, 240.12b-2 (1984). *See also U.S. v. Corr*, 543 F.2d 1042, 1050 (2d Cir. 1976); *S.E.C. v. International Chemical Development Corp.*, 469 F.2d 20, 28 (10th Cir. 1972); *Pennaluna & Co. v. S.E.C.*, 410 F.2d 861, 866 (9th Cir. 1969), *cert. denied*, 369 U.S. 1007 (1970). *Cf. United States v. Byrum*, 408 U.S. 125, 138 n. 13 (1972).

against the spectrum of, on one side, the purchase of a *de minimus* amount of stock attended by little or no participation in the enterprise,[13] to the other extreme of a 100% purchase by a person who manages and controls the business.[14] As plaintiff-purchasers become increasingly able to protect themselves through control or influence over the enterprise, and concomitantly less dependent upon others for a return of profit, such persons progressively become less in need of securities law protection and hence less reason exists to extend coverage to them.

Although not stated explicitly in *Howey*, closely related to an investor's dependence *vel non* upon others is the extent to which a fiduciary or trust relationship is involved in a transaction involving stock. As earlier discussed (*supra* at p. 11-13), a prominent theme of the legislative history of the securities laws is to regard persons who use the money of others upon a promise of profits—the principal targets of the securities laws—as "trustees." This theme was fundamental to the holding in *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971), which emphasized that "Congress made clear that 'disregard of trust relationships by those whom the law should regard as fiduciaries, are all a single seamless web' along with manipulation, investor's ignorance, and the like." *Id.* at 11-12 (citing H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6). In short, the greater the degree of dependence upon others for

[13]Because no *per se* rule applies there is no need to address whether the phrase "solely from the efforts of others," used in *Howey*, 328 U.S. at 301, should be read literally. *See Forman*, 421 U.S. at 852 n. 16; *Lino v. City Investing Co.*, 487 F.2d 689, 692 (3d Cir. 1973).

[14]While we do not expouse a *per se* rule, it is difficult to envision a situation where a 100% stock purchaser who buys from a sole shareholder and thereafter manages the business, would be covered by the securities laws. Such a situation bespeaks a private, negotiated transaction between parties of equivalent bargaining power, no widespread offering, no public investor, etc., and hence, absent strong factors compelling coverage will likely not be subject to the securities laws.

control or management of the enterprise,[15] the more important is the element of trust, and the more likely it will be that the securities laws will apply.

The presence of traditional characteristics in the stock transferred also plays a role in the economic analysis.[16] Traditional instruments will as a practical matter presumptively be covered by the securities laws, because on their faces "they answer to the name or description," *Joiner*, 320 U.S. at 351, of the statutory definition. In such cases the practical burden falls upon the defendant to show that affording securities law coverage to the transaction serves no statutory purpose. The result of this allocation of burdens will be that "most instruments bearing these traditional titles are likely to be covered by the statutes," *Forman*, 421 U.S. at 850, because application of the securities laws is strengthened where traditional titles and characteristics are present. *Id.* at 851-52. Conversely, non-traditional instruments, which by definition are variable in character and do not fall within the statutory definition, as a practical matter presumptively will not be covered by the securities laws, until it is shown that the statutory purposes will be served by such a result.[17]

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[15]In *Superintendent*, the corporation itself was the defrauded party. The entity was totally subject to the will of the incoming shareholders who perpetrated the fraud.

[16]*Forman* states that the characteristics traditionally associated with stock are the following: the right to receive dividends contingent upon an apportionment of profits; ability to be pledged or hypothecated; conferral of voting rights in proportion to the number of shares owned; and the ability to appreciate in value. 421 U.S. at 851.

[17]Although not here applicable, *Weaver* and *Daniel* show that the existence of other federal law affording special protection to a would-be securities law plaintiff also is a factor in the economic analysis. In *Weaver*, the federal banking laws provided protection to the plaintiff; in *Daniel* the federal pension laws accorded such protection. The fact that other bodies of federal law provided a great measure of protection rendered it "unnecessary," *Weaver*, 455 U.S. at 559, to accord federal securities law protection as well.

D. The *Howey* Economic Analysis Is Effectively Applied To Stock Transactions

Application of the *Howey* analysis to transactions involving stock does no more than evaluate the presence of factors which this Court has held are determinants of whether any transaction can be said to involve securities in the federal law sense. There is nothing revolutionary in this approach; to the contrary, *Howey* and its progeny have applied no other manner of evaluation.

Because of hypothesized cases involving stock where application of the *Howey* analysis may be difficult, some courts reject the approach in its entirety, on the rationale that the difficulty of line-drawing shows the distinction to be incapable of effective application in a stock context. *Ruefenacht v. O'Halloran*, 737 F.2d at 332-33; *Daily v. Morgan*, 701 F.2d at 503; *Golden v. Garafalo*, 678 F.2d at 1145-46, 1149 (Lumbard J., dissenting). *See also* FitzGibbon, *What Is a Security?—A Redefinition Based on Eligibility to Participate in the Financial Markets*, 64 Minn. L. Rev. 893, 905-08 (1980); Coffey, *The Economic Realities of a "Security": Is there a More Meaningful Formula?*, 18 Case W. Res. L. Rev. 367, 374 (1967).

This is the tail wagging the dog. These courts turn a blind eye to fundamental distinctions in the securities laws because the means of carrying out Congress' intent are anticipated (or speculated) to be unworkable, even though *Howey* and other decisional precedent show the contrary to be true. Such an approach "is to go awfully far for the sake of avoiding having to make some distinctions." *Sutter v. Groen*, 687 F.2d at 202. *Accord Golden v. Garafalo*, 678 F2d. at 1149 (Lumbard, J., dissenting).[18]

Nor does application of the *Howey* analysis to stock transactions result in "arbitrary" distinctions. *See Ruefenacht v.*

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[18]The Securities and Exchange Commission may have an important role to play in refining and amplifying the *Howey* factors in specific situations, consistent with its statutory role to promulgate rules and regulations "for the protection of investors." 15 U.S.C. § 77c (b) (1982).

O'Halloran, 737 F.2d at 335-36; *Golden v. Garafalo*, 678 F.2d at 1146. There is nothing arbitrary about the fundamental investor/non-investor distinction underlying the securities laws; the *Howey* approach allows this distinction to be made in specific cases by reference to factors designed to determine whether particular persons are within the intended ambit of securities law protection. It is not arbitrary to accord securities law coverage only to those parties to a stock transaction who fall within the classes Congress sought to protect, rather than woodenly extending coverage to persons fully able to protect themselves, simply because an instrument denominated "stock" is utilized in the transaction.[19]

Neither does application of an economic evaluation to stock transactions open the "floodgates" of federal court litigation. It is submitted that coverage of most transactions—particularly those involving the organized exchanges, widespread offerings, and recognized fiduciary relationships—will be clear. Moreover, we ask which approach to coverage truly opens the federal litigation "floodgates," an approach which permits an economic evaluation with the result that some cases will be excluded from federal law coverage, or one which automatically places within federal jurisdiction an infinite number of garden-variety commercial transactions involving stock.

Those courts which reject application of the *Howey* evaluation to stock transfers, and instead embrace a "traditional/non-traditional stock" distinction as the basic theorum of securities law coverage, view securities transactions only from the vantage point of the instrument involved, and do not properly take into consideration the classes of persons or nature of transactions intended to be covered. *See Landreth Timber Co. v.*

[19]Concerns that application of an economic analysis would exclude from coverage many tender offers are unjustified. *See Daily v. Morgan*, 701 F.2d at 503. As an area singled out for special protection, *see e.g.*, 15 U.S.C. § 78(n) (1982), tender offers may be imbued with a specific Congressional intent to accord federal law protection. This factor may of itself be controlling in the determination of coverage.

Landreth, 731 F.2d at 1352. Such courts fail to accord any manner of recognition to the primary statutory purposes to protect *persons* (*i.e.*, investors) who passively invest in financial instruments, and not to purchasers of assets, such as a business, through the transfer of stock.[20]

Nor is automatically extending coverage to stock necessary to facilitate the flow of capital or the marketability of instruments. *Ruefenacht v. O'Halloran*, 737 F.2d at 324. Surely the capital raising functions of the organized markets (where most transactions clearly are covered by federal law) will in no way be inhibited by a case-by-case analysis of coverage to be accorded transactions in other spheres. Nor will non-exchange transactions be inhibited, because "doubts as to the coverage of the antifraud provisions of the securities laws are unlikely to impede otherwise profitable transactions by persons able to protect themselves by contract." *Golden v. Garafolo*, 678 F.2d at 1150 (Lumbard, J., dissenting).

Because purchasers of assets, such as a business, fundamentally seek to "use or consume the item purchased," *Forman*, 421 U.S. at 853, it is entirely fair and proper to relegate such persons to common law relief. State law remedies, including remedies based upon contract and deceit, are specifically adapted and fully adequate to protect the purchaser of a business enterprise. *See S.E.C. v. Capital Gains Bureau, Inc.*, 375 U.S. 180, 194-95 (1963) (observing that common law "doctrines of fraud and deceit" are specifically adapted to controversies concerning "tangible items of wealth" as opposed to "such intangibles as . . . securities"); *and Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-80 (1977) (declining to "bring within [the securities laws] a wide variety of corporate conduct tradi-

[20]The "traditional/non-traditional" approach finds no authoritative support in the proposition that because the securities laws are "remedial" they should be expansively applied. This Court has long made clear that specific rules of statutory construction (such as that requiring expansive reading of remedial legislation) "long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose." *Joiner*, 320 U.S. at 350.

tionally left to state regulation."). *Green* held that undue "extension of the federal securities laws would overlap and quite possibly interfere with state corporate law," and observed that "[a]bsent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities . . . ." *Green* explicitly declined to extend the federal securities laws "to 'cover the corporate universe.'" *Id.* at 479-80. *See also Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 40-41 (1977); *Forman*, 421 U.S. at 859 n.26; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 n.9, *reh. denied*, 423 U.S. 884 (1975).

The securities laws provide significant advantages to plaintiffs, and hence present a potential for abuse where not needed to compensate for the dependent position of a true stock investor in the federal law sense. As this Court observed in *Wilko v. Swan*, 346 U.S. 427, 435 (1953), "the Securities Act was drafted with an eye to the disadvantages under which buyers labor." This Court's decisions accordingly have construed the securities laws liberally to minimize procedural and substantive burdens recognized at common law. *See, e.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 388-89 (1983). While the disadvantageous position of a security investor justifies such special protections, the same cannot be said for a non-investor. Rather, conferring special substantive and procedural advantages to a plaintiff in what amounts to the sale of a business by means of a transfer of stock, presents dangers of serious abuse. Such plaintiffs are thus enabled to ignore negotiated contract terms by alleging a host of "nondisclosures" after obtaining possession of the business, and to contend that each such omitted fact, whether or not actually relied upon, constitutes a fraud justifying rescission. As this Court stated in *Blue Chips Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975): "There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness . . . ." *Id.* at 739. Extending securites law coverage to non-investors who purchase assets to use or consume only exacerbates these concerns.

POINT II

THE PRESENT TRANSACTION FAILS TO QUALIFY FOR COVERAGE UNDER THE FEDERAL SECURITIES LAWS

The trial court held that because an economic analysis of the subject transaction showed Ruefenacht to have intended to exercise joint control of the Continental business with a co-shareholder and to have been an active investor participating significantly in the management of the business (J.A. 61a), the transaction failed to meet the standards announced in *Howey* and *Forman* for securities law coverage in that "the profits of the enterprise would not be derived 'solely' or substantially from the efforts of others." (J.A. 61a). This conclusion is fully consistent with the purposes of the securities laws, and with decisional authority in this Court construing those enactments.

The record establishes (*see supra* at p. 3-5) that, in connection with his purchase of Continental's stock, Ruefenacht acquired control over the affairs of the business such that no decision fundamental to the company's structure or operations could be made without his approval. It also was established that Ruefenacht actively participated in the enterprise in significant ways (*e.g.*, by attending numerous regular meetings with suppliers, soliciting contracts to import beverages on behalf of the firm, participating in hiring key personnel, and issuing directions to the company's counsel regarding securing wine label approvals), such that he was in a position to substantially influence corporate profitability. Part of the consideration for these efforts was to be a salary from the company of $24,000 annually, and the fact that Ruefenacht would be receiving a salary and other compensation as a Continental employee was confirmed in sworn representations made as a basis for obtaining a state liquor license (or solicitor's permit).

These circumstances bespeak an intention by Ruefenacht to use the business, assets and operations of Continental to earn a livelihood through *his own* participation in the business, and

not a purpose to passively invest in a financial instrument with profits from the investment to come from the efforts of others. In short, the economic substance of this transaction was the purchase by Ruefenacht of one-half of the Continental business for his own substantial entrepreneurial purposes, accomplished by means of a transfer to him of 50% of the company's stock.

Application of the *Howey* analysis to this transaction demonstrates that no federal securities law purposes are advanced by according coverage here. The *Howey* requirement of a "common venture," *supra* at p. 24-25, is not met, because it is clear that the stock transfer here was a purely private transaction, "negotiated one-on-one," *Weaver*, 455 U.S. at 560, with "unique" features, and was "not designed to be traded publicly." *Id.* No "public" offering or investment was involved in the transaction, and no organized exchange, or the regulation thereof, is concerned in any way. *United States v. Naftalin*, 441 U.S. 768 (1979). Hence, the purposes of the securities laws to protect such transactions or persons are in no way implicated.

The *Howey* standard requiring dependence upon others for a return of profit, *supra* at p. 25-28, is also not satisfied, by reason of Ruefenacht's extensive veto rights over the company's affairs, taken together with his active participation therein and concomitant ability to fundamentally influence corporate direction and profitability. These factors provided Ruefenacht with a significant "measure of control," *Weaver*, 455 U.S. at 560, over the enterprise, such that he was substantially dependent upon himself, not others, for a return of funds from the business. He therefore is not a member of the class of dependent investors which *Howey* found the securities laws seek to protect, and consequently should not be accorded securities law coverage.[21]

[21]The stock purchased by Ruefenacht lacked several of the "traditional" characteristics of stock, *see Forman*, 421 U.S. at 851-52, further militating against coverage. Although the Magistrate made no specific finding on this point, the record is clear that the stock lacked the characteristics of free transferability, the right to dividends and the right to be pledged or hypothecated. These restrictions are found in the shareholders agreement (R. App. 238a-269a) which the Magistrate found plaintiff intended to sign (J.A. 52a). Such restrictions, moreover, were in part specifically confirmed by plaintiff who testified that a transfer of shares was one of the "top level" decisions both he and Birkle could veto. (R. Tr. Nov. 19, 1982, T137-11 to T138-23).

CONCLUSION

For all of the above reasons, the judgment of the Court of Appeals should be reversed and the case remanded to the District Court with instructions to dismiss the complaint with costs and disbursements.

Respectfully submitted,

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